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No. 69

In the Supreme Court of the United States

OCTOBER TERM, 1945

LILLIAN BOEHM, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 62–68) is not reported. The opinion of the Circuit Court of Appeals (R. 76–80) is reported in 146 F. 2d 553.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 10, 1945 (R. 92). The petition for a writ of certiorari was filed on May 10, 1945, and granted on June 11, 1945 (R. 93). The jurisdiction of this Court is invoked under

Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, as found by the Tax Court, certain stock, with respect to which taxpayer claimed a loss deduction in 1937, did not become worthless in that year.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved may be found in the Appendix, *infra*, pp. 38–39.

STATEMENT

The facts were stipulated (R. 20–61) and the Tax Court based its findings upon the stipulation (R. 62).

The Hartman Corporation (hereafter called "Hartman") was a Virginia company, organized in 1916 to acquire the capital stock of Hartman Furniture and Carpet Company, an Illinois corporation, and its affiliates, engaged in the business of selling furniture, carpets, and household goods (R. 20). Through subsidiary companies, Hartman operated a chain of retail stores, principally in the Middle West, for the sale of this type of merchandise. The Hartman Corporation was authorized to issue two classes of stock, known as

Class A and Class B stock.[1] (R. 56.) In 1929 taxpayer purchased 1,100 shares of Class A stock of Hartman for $32,440 (R. 20).

Subsequent to April 4, 1932, taxpayer received a letter of that date from Hartman issued by order of its directors, reporting policies adopted and procedures followed as a consequence of the then current business depression, discussing shrinkage of sales, decline in worth of assets, unprecedented credit and corporate losses, and stressing the reduction of operating costs and loans payable, and submitting its balance sheets as of December 31, 1931. The balance sheet showed assets and liabilities of $15,401,097.97 and a total net

[1] The rights and privileges of these two classes of stock are described in the bill of complaint for appointment of a receiver of Hartman, included in the stipulation of facts, as follows (R. 25-26):

"The shares of Class 'A' stock are entitled to cumulative dividends at the rate of $2.00 per share per annum, and no more, payable in preference to dividends under Class 'B' stock, and redeemable at $30.00 per share and accrued dividends. Upon the dissolution of the corporation the Class 'A' stock is entitled to share equally and ratably with Class 'B' shares in the distribution of the assets until the holder of each share of Class 'A' stock shall have received $30.00 per share plus accrued dividends. The shares of Class 'B' stock have a stated value of $10.00 a share, and are entitled to dividends only after cumulative dividends at the rate of $2.00 per share per annum have been paid on Class 'A' stock, and said Class 'B' stock is entitled to share equally with Class 'A' stock in the distribution of the assets of the corporation until Class 'A' stock shall have received $30.00 per share and accrued dividends, and thereafter all assets of said corporation are to be distributed ratably among the holders of Class 'B' stock without participation with the holders of Class 'A' stock."

worth of $9,410,659.50. (R. 20, 42–47.) On May 4, 1932, Martin L. Straus, its president, sent another letter to stockholders, informing them that business had not shown any improvement and outlining the measures being taken to counteract the existing unfavorable business conditions (R. 47–49). In the following month, on June 16, 1932, Mr. Straus and Elias Mayer were appointed equity receivers for the corporation by the United States District Court for the Northern District of Illinois, upon the admission by Hartman of the allegations of a bill of complaint by a creditor (R. 38–42). The bill set forth that Hartman and its subsidiary companies sustained losses in 1931 from closing stores amounting to $761,648 and from necessary liquidation approximately $1,150,000 (R. 28–29); and alleged, in addition, that Hartman sustained operating losses in 1930 in the amount of $1,830,000; in 1931, $2,076,266.39; from January, 1932, to June 16, 1932, $400,000 (R. 29); the corporation's business was then being operated at a great financial loss (R. 29); it was unable to meet and pay its obligations due and to become due (R. 29); but that if its assets were administered through a receivership they would be sufficient to pay in full all Hartman liabilities, leaving a surplus for its stockholders (R. 33).

On December 16, 1932, a stockholders' derivative action (hereinafter called the Graham suit)

was instituted in the Supreme Court of the State of New York against the corporation and nine members of its board of directors, some of whom were also officers (R. 22, 55, 56–57). All of the individual defendants were financially responsible and several were prominent business men (R. 23). The plaintiffs were taxpayer and eight other stockholders of the corporation, in the aggregate representing 4,407 shares of Class A stock and 115½ shares of Class B stock[2] (R. 55–56). They brought the suit (R. 55)—

> on behalf of themselves as stockholders of The Hartman Corporation, and on behalf of the said Company and all other stockholders of said Company similarly situated, who may join with the plaintiffs in, and contribute to the expenses of, this suit * * *.

The complaint charged the individual defendants with waste, extravagance, mismanagement, neglect, and the fraudulent violation of their duties as officers and directors, with the issuance of false letters, statements and reports to the stockholders relating to the assets, liabilities and financial condition of the corporation and with concealing its true state and condition from the stockholders, including the plaintiffs (R. 57–58, 60). The relief requested was as follows (R. 61):

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[2] Prior to 1930 (R. 56) and in June 1932 (R. 25, 37) there were approximately 60,000 Class A shares outstanding and more than 335,000 Class B shares.

1. That the defendants and each of them, except The Hartman Corporation, be directed to account to the defendant Corporation for their official conduct as officers and/or directors thereof, as the case may be, in the management and disposition of the property and affairs of the said Corporation, and in respect to all of the matters set forth in this complaint;

2. That the liability of the defendants and each of them, be ascertained and determined, and that they be adjudged and decreed to pay into the Treasury of the defendant Corporation the amount of the loss and damage which shall be found to have been sustained by the Corporation by reason of their aforesaid wrongful acts and conduct;

3. That this Court make and award suitable allowance to the plaintiffs for counsel fees and other necessary disbursements incurred in the prosecution of this action on behalf of the defendant Corporation and stockholders, and that it be decreed that the defendant Corporation pay the same to the plaintiffs, and that the plaintiffs have judgment therefor, together with the costs and taxable disbursements of this action.

4. That the plaintiffs have such other and further relief as may be just, equitable, and proper.

The receivers continued to operate Hartman until May 26, 1933 (R. 20). As of that day, a newly organized Delaware corporation called

"Hartman's, Inc." purchased at a bankruptcy sale the assets of Hartman Furniture and Carpet Company, the wholly owned subsidiary of Hartman, for the sum of $501,000 in cash and an agreement to procure a waiver of certain inter-company claims against the bankrupt estate. The stock of the new company was issued to creditors of the subsidiary in settlement of claims. Stockholders of Hartman were given the right to subscribe for stock and debentures of the new company. However, taxpayer did not exercise this right and did not acquire any interest in the new company in 1933 or afterwards. (R. 21.)

Three reports were filed with the federal district court by the receivers of Hartman. In the first report filed and approved on August 10, 1934, assets were listed as $39,593.13 in cash and the Graham suit; liabilities, consisting of outstanding claims, were stated to aggregate $707,430.67. The receivers recommended that claims in a total of $630,574.57 be allowed. The court awarded $3,500 compensation to each of the receivers and $5,000 as attorneys' fees. The receivers filed a second report on July 11, 1935, listing as assets $27,192.51 in cash and the Graham suit pending against the directors; and as liabilities, the same amount, namely, $707,430.67, representing the total outstanding claims set forth in their first report. They recommended that a dividend of 4% be paid on the allowed claims of $630,574.57, and that one claim amounting to $176,856.10 be disallowed. By

an order of the same date the court adopted their report and recommendations. On August 26, 1935, one of the two receivers was released from further duties. (R. 21.)

The remaining receiver filed his final report with the court on September 30, 1937. He showed as the sole remaining asset, cash in the amount of $1,909.94; claims totaled $630,574.57. On the same date the court discharged the receiver, allowed him and counsel compensation totaling $900, and provided that the balance of assets be distributed to the creditors. (R. 21–22.)

In her income tax return for 1934, taxpayer claimed a deduction from gross income in the amount of $32,302 as a loss due to the worthlessness of her 1,100 shares of Class A stock in the corporation. The deduction was denied by the Commissioner on the ground that the stock did not become worthless in the year 1934. (R. 22.)

During the years 1933 to 1936, inclusive, extensive examinations in the Graham suit were made of certain of the defendants. Many hundreds of pages of testimony were taken and numerous exhibits were offered in evidence. Pursuant to an order of the New York Supreme Court, taxpayer and her co-plaintiffs paid counsel fees, transportation, and hotel expenses of certain of the defendants' attorneys, amounting to approximately $800, and expended approximately $2,000, exclusive of fees, in defraying disbursements of their counsel

while attending the examinations, in stenographic costs and printing charges. (R. 22–23.)

At the conclusion of the examinations and shortly before trial, negotiations were commenced for settlement of the action, and on February 20, 1937, a settlement was consummated. Under its terms the defendant directors paid taxpayer and her co-plaintiff stockholders the sum of $50,000 in full settlement and discharge of their claims and cause of action. In connection with the settlement, taxpayer and the other stockholders released all their rights and claims arising out of the acts committed by the defendants as alleged in the complaint. (R. 23.) The suit was dismissed on May 14, 1937 (R. 66). Taxpayer's proportionate share of the $50,000, after payment of counsel fees and expenses, amounted to $12,500. At the time of the settlement the assets of the corporation consisted of $1,909.94 in cash and the Graham suit, and its liabilities amounted to $630,574.57, representing the claims allowed by the federal district court. (R. 23.)

In her income tax return for 1937, taxpayer claimed a deduction from gross income in the amount of $19,940, as a loss due to the worthlessness of her stock in the corporation, being the difference between $32,440, its purchase price, and the $12,500 received pursuant to the settlement. The Commissioner denied the deduction and included in her gross income for the year 1937 this

sum of $12,500. (R. 23.) At no time has taxpayer received any deduction from gross income in the determination of her income tax liability by reason of her investment in the Hartman stock (R. 24).

Taxpayer raised two issues in the Tax Court: (1) whether her stock in the corporation became worthless in 1937, as she claimed; (2) whether the Commissioner properly included in her gross income for 1937 the sum of $12,500 paid as a result of the settlement of the Graham suit (R. 62). The Tax Court found in favor of the Commissioner on both issues (R. 67–68), denied taxpayer's motion for a rehearing (R. 2, 17–19), and redetermined deficiencies for 1937 in the sum of $5,957.86[3] (R. 69).

The court below affirmed the Tax Court as to the first question, but reversed as to the second, holding that the sum of $12,500 must be regarded as a capital item in reduction of loss and that the Tax Court had erred in ruling that taxpayer had not proved the payment was not income (R. 76–80). A petition by taxpayer for rehearing (R. 81–89) was denied (R. 91). Taxpayer alone sought certiorari in this Court.[4]

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[3] Other issues raised in taxpayer's petition were disposed of by stipulation prior to the hearing in the Tax Court (R. 24).

[4] Thus, the balance of the tax deficiency determined by the Tax Court remaining in controversy amounts approximately to $3,000.

SUMMARY OF ARGUMENT

I.

Taxpayer's contention that, under Section 23 (e) of the Revenue Act of 1936 permitting deductions of "losses sustained during the taxable year", the question to be determined is not whether her stock actually became worthless before 1937 but whether she honestly believed that it had some value until settlement of the litigation, finds express refutation in the language of the statute and of regulations having the force of law. The legal test prescribed is an objective and not a subjective one. The question is when the stock in fact became worthless, not when taxpayer learned that it was worthless or when she honestly believed it became worthless. The regulations have long generally required deductible losses to be fixed by identifiable events. The requirement that losses be deducted in the year in which they are actually sustained calls for a practical test, since a test conditioned by the state of mind of the individual taxpayer would present insuperable obstacles to tax administration.

The language of the statute does not suggest a subjective test and is to be contrasted with that used in the bad debt provision where deduction was permitted when "ascertained to be worthless and charged off within the taxable year." Section 23 (k), Revenue Act of 1936. Even under the bad debt provision, there has been a difference of judicial opinion as to whether the test

was purely subjective. This caused constant administrative difficulties, and by the Revenue Act of 1942, Section 124, Congress amended the bad debt provision to permit deduction only of "debts which became worthless within the taxable year." Thus, even in the case of bad debts, Congress now prescribes an objective rather than a subjective test. While taxpayer's appraisal is one of the factors to be considered in the ultimate determination of value or lack of value in a given tax year, especially where a going business is concerned, taxpayer's appraisal is but one of the factors to be considered, and where there are other relevant factors it is the function of the Tax Court to weigh all of the factors in the case, and the belief of taxpayer as to value is certainly not necessarily the controlling element.

II

The finding of the Tax Court that the loss was not in fact sustained in the taxable year was correctly held by the court below to be supported by substantial evidence. Plainly a pure question of fact is involved, although the Tax Court based its findings upon stipulated facts. The choice among conflicting inferences which fairly may be drawn from the stipulated facts lies within the exclusive jurisdiction of the Tax Court. Loss deductions, like other deductions, are matters of legislative grace and the burden is upon the taxpayer to establish the loss in the year in which the deduc-

tion is claimed. Here there was a succession of identifiable events occurring many years before the taxable year, which taken separately or in combination proved the stock to be completely worthless and sustain the finding of the Tax Court. The loss must be taken in the year in which it is actually sustained, even though it is possible that there may be some recovery on the investment in the indefinite future. Even though such possibility at some later date actually results in substantial recovery, the cases hold that it is the fairer course to allow a taxpayer to deduct the loss in the year when suffered and to pay a tax on the amount of the loss recovered in the later year. Moreover, as a matter of fact, what taxpayer here recouped obviously does not represent a recovery in the Graham suit since under the theory of that derivative action the recovery would necessarily have been paid to the corporation's creditors or divided among all the stockholders. Indeed, taxpayer's present claim is inconsistent with her previous attempt to deduct the loss in 1934 and hence even on the basis of a subjective appraisal, the evidence is conflicting and the Tax Court surely could reasonably find against taxpayer. Whether in a given case the likelihood of recoupment is real, or as here found, speculative, is peculiarly a fact question for determination by the Tax Court, which here on substantial evidence was resolved against taxpayer.

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ARGUMENT

I

THE STATUTE REQUIRES THE LOSS TO BE DEDUCTED IN THE TAXABLE YEAR IN WHICH IT WAS IN FACT SUSTAINED

The applicable statute permits deductions of "losses sustained during the taxable year and not compensated for by insurance or otherwise" (Section 23 (e), Revenue Act of 1936, Appendix, *infra*, p. 38). The identical language is found unchanged in successive Revenue Acts for many preceding years beginning with the Revenue Act of 1918, c. 18, 40 Stat. 1057, Section 214 (a) (4),[5] was re-enacted in the Revenue Act of 1938, c. 289, 52 Stat. 447, Section 23 (e), and is presently continued in the Internal Revenue Code, Section 23 (e). Moreover, long standing Treasury Regula-

[5] Indeed, the provision may be traced to the Civil War income tax legislation, Act of March 2, 1867, c. 169, 14 Stat. 471, Section 13, permitting deduction of "losses actually sustained during the year arising from fires, shipwreck, or incurred in trade". The Act of August 27, 1894, c. 349, 28 Stat. 509, Section 28, permitted deduction of—

"losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise, * * *"

The same language was repeated in the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Section II B. The Revenue Act of 1916, c. 463, 39 Stat. 756, Section 5 (a), Fourth, read—

"Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: * * *"

tions expressly mark out the Congressional intent, thus repeatedly manifested over a period of many years, that deductible losses must not only be "bona fide" but also "actually sustained during the taxable period for which allowed." (Treasury Regulations 94, Art. 23 (e)–1, Appendix, *infra*, pp. 38–39.)* On familiar principles, Treasury Regulations, long continued without substantial change, and applying to an unamended or substantially re-enacted statute, are deemed to have received Congressional approval and have the force of law. *Taft* v. *Commissioner*, 304 U. S. 351, 357; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Douglas* v. *Commissioner*, 322 U. S. 275, 281–282.

Thus, taxpayer's contention, as stated in the opinion below (R. 79)—

> that the question to be determined is not whether the stock actually became worthless before 1937 but whether she honestly believed that it had some value until settlement of the litigation

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*The complete sentence in the Regulations reads:

"In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed."

The identical language is contained in Article 23 (e)–1 of Regulations 86, under the Revenue Act of 1934; Article 23 (e)–1 of Regulations 101, under the Revenue Act of 1938; Section 19.23 (e)–1 of Regulations 103, under the Internal Revenue Code; and Section 29.23 (e)–1 of Regulations 111, under the Internal Revenue Code.

finds express refutation in the language of the statute and of the Regulations, having the force of law. On the contrary, these required the court below to approve "the objective rather than the subjective test in determining the worthlessness of stock" (R. 79); the prescribed legal test includes both *bona fides* and loss actually sustained during the taxable period.

The Regulations further contain specific provision covering worthless stock losses. Here it is again made clear that it is only losses in fact that are deductible. Thus, "paper" losses are excluded. A taxpayer may not claim a loss "merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise." (Treasury Regulations 94, Art. 23 (e)–4, Appendix, *infra*, p. 39.) In such cases the loss is "that actually suffered when the stock is disposed of." (Treasury Regulations 94, Art. 23 (e)–4.) If, before being disposed of, the stock becomes worthless, its cost or other basis (Art. 23 (e)–4)—

> is deductible by the owner for the taxable year in which the stock became worthless, provided a satisfactory showing is made of its worthlessness.

Hence, plainly the test contemplated is neither the year in which the taxpayer learned that it was worthless nor that in which she honestly believed it became worthless.

The treatment of theft and embezzlement losses illustrates the objective concept for loss deduc-

tions. Thus Regulations 94, Article 43–2, provides "A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained." *First Nat. Bank of Sharon, Pa.* v. *Heiner,* 66 F. 2d 925 (C. C. A. 3d); *Borden* v. *Commissioner,* 101 F. 2d 44 (C. C. A. 2d); see also *Burnet* v. *Huff,* 288 U. S. 156. Cf. *Boston Consol. Gas Co.* v. *Commissioner,* 128 F. 2d 473 (C. C. A. 1st), holding that an exception should be made where the taxpayer could not allocate the embezzled funds to particular years under another provision of the same Article, expressly authorizing an amended return for the prior year, including the amount of loss among deductions from gross income and a claim for refund of the excess tax paid by reason of the failure to deduct the loss in the original return. This machinery was available to the instant taxpayer. The significant point is that the loss is regarded as having been sustained only in the year when it in fact occurred; a deduction is allowable in any other year only when necessary to reflect income correctly, and the state of mind of the taxpayer is immaterial.

For like reason the Regulations require "in general", deductible losses to be "fixed by identifiable events." (Regulations 94, Article 23 (e)–1.) As expressed by the Board of Tax Appeals in *Morton* v. *Commissioner,* 38 B. T. A. 1270, 1278, affirmed, 112 F. 2d 320 (C. C. A. 7th):

> Such events are called "identifiable" in that they are likely to be immediately known by everyone having an interest by way of stockholdings or otherwise in the affairs of the corporation; but, regardless of the adjective used to describe them, they are important for tax purposes because they limit or destroy the potential value of stock.

Cf. *United States* v. *White Dental Co.*, 274 U. S. 398, 401. Thus, here again the controlling factor is external. The evidence is equally available to the officers of the Treasury and to the taxpayer, and does not depend upon the mental processes of any individual. As this Court said in *Lucas* v. *American Code Co.*, 280 U. S. 445, 449, in language often quoted:

> The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal test.

The general requirement of an identifiable event calls for a practical test, since a test conditioned by the state of mind of the individual taxpayer would present insuperable obstacles to tax administration. *Lambert* v. *Commissioner*, 108 F. 2d 624 (C. C. A. 10th); *Bartlett* v. *Commissioner*, 114 F. 2d 634, 638 (C. C. A. 4th).

The choice of statutory language does not suggest a subjective test. Another subdivision of the very Section of the statute where the loss provision is found, permitted a debt deduction when "ascertained to be worthless and charged off

within the taxable year". (Section 23 (k), Revenue Act of 1936.) As hereinafter noted, even under that Section the courts have not agreed whether a purely subjective test was provided. But the contrast between the loss and the debt provisions has often been observed by the courts. Referring to the Revenue Act here involved, in *Rosenthal* v. *Helvering*, 124 F. 2d 474 (C. C. A. 2d), the court said (p. 476):

> The statute makes a distinction between the deduction of "losses" under § 23 (e) and (f), and of "bad debts" under § 23 (k). "Losses" must be deducted in the year in which they are "sustained" and if the taxpayer fails to learn of them in time, he loses the privilege; debts, on the other hand, must be deducted in the year in which the taxpayer "ascertains" them to be "worthless," and nobody understands that this imposes upon him the absolute risk of selecting the year when they actually become so.

To the same effect are *Commissioner* v. *MacDonald Eng. Co.*, 102 F. 2d 942, 944 (C. C. A. 7th); *Bartlett* v. *Commissioner*, 114 F. 2d 634, 638 (C. C. A. 4th); *San Joaquin Brick Co.* v. *Commissioner*, 130 F. 2d 220, 227 (C. C. A. 9th); *Rassieur* v. *Commissioner*, 129 F. 2d 820 (C. C. A. 8th).

Moreover, "these venerable requirements [of ascertainment of worthlessness by the taxpayer and charge off] had caused constant administra-

tive difficulties and a volume of litigation." (5 Mertens, Law of Federal Income Taxation (1945 Supp.), Sec. 30.27a (new), p. 170); besides, the cases were not in accord, some holding the year of ascertainment was that in which a prudent person would have considered the debt uncollectible; others holding that the proper year was that in which the taxpayer honestly ascertained the fact, no matter how much earlier a reasonably prudent person would have done so. *Rosenthal* v. *Helvering,* 124 F. 2d 474, 476 (C. C. A. 2d). To meet these difficulties, Congress, by Section 124 of the Revenue Act of 1942, c. 619, 56 Stat. 798 (26 U. S. C. Supp. IV, Sec. 23), amended the bad debt provision (Internal Revenue Code, Section 23 (k) (1)) to permit deduction of "debts which became worthless within the taxable year", retroactive as to taxable years beginning after December 31, 1938. Cf. *Cittadini* v. *Commissioner,* 139 F. 2d 29, 31 (C. C. A. 4th). Thereby, the standard of worthlessness in fact was substituted for the former ascertainment of worthlessness,[1] and the objective test long applied to loss deductions became also the rule for bad debts. The amendment was adopted in response to a suggestion

[1] The Ways and Means Committee Report, recommending the amendment, confirms this construction. H. Rep. No. 2333, 77th Cong., 1st Sess., p. 76 (1942–2 Cum. Bull. 372, 431):

"This section amends section 23 (k) of the Code to allow a deduction for a debt which becomes worthless during the taxable year regardless of the year in which the debt is ascertained to be worthless or charged off."

by the Treasury at the outset of the hearings on the 1942 bill,[8] and clearly expresses the intention to govern deductibility of bad debts and worthless stock losses by the same objective rule. To assure greater elasticity and equity in administration, a further amendment was at the same time proposed by the Treasury allowing a special seven year statute of limitations with respect to refund claims relating to deductions both on account of worthless stock losses and bad debts (in place of the former three year statute).[9] This sug-

[8] Statement of Randolph Paul, Hearings Before Ways and Means Committee, 77th Cong., 2d Sess., Revenue Revision of 1942, Vol. I, pp. 92–93:

"*Statute of limitations on bad debts and worthless stock losses.*—The difficulties surrounding the deduction for bad debts and worthless stock losses have long been familiar sources of irritation to taxpayers and the Commissioner alike. It is far from easy to ascertain when a debt is bad or when a share of stock becomes worthless. At the same time, the taxpayer must select the proper year before the statute of limitations has run with respect to that year.

"Much litigation is occasioned by the artificial barrier thus thrown up by the statute of limitations, as a taxpayer who chose one year only to be met with the claim that an earlier but barred year was the correct year must battle to defend his choice or lose the deduction entirely.

"It is believed that this useless litigation and many of the difficulties in this field can be avoided by, first, eliminating the ascertainment of worthlessness and the charge-off requirements in the case of bad debts—including securities producing capital losses—and, second, allowing a 7-year statute of limitations with respect to refund claims relating to a deduction on account of these items. Interest should not be allowed for the interval between the expiration of the normal statute of limitations and 6 months after the claim was filed."

[9] See fn. 8, *supra*.

gestion was also enacted into law and made applicable to taxable years beginning after December 31, 1937. (Revenue Act of 1942, Section 169, adding Section 322 (b) (5) to the Internal Revenue Code; and as amended by the Revenue Act of 1943, c. 63, 58 Stat. 26, Section 504.) Consequently, for the court below to have sustained taxpayer's contention would have frustrated the legislative scheme; the legislative history shows that Congress intends the loss to be taken in the year in which the stock actually became worthless, even though the taxpayer honestly believed the loss occurred in a different year.

True, taxpayer's appraisal is one of the factors to be considered in the ultimate determination of value or lack of value in a given tax year, and where a going business is concerned and there is "hope that a business although involved might be saved and value in the stock established" (*Forbes* v. *Commissioner*, 62 F. 2d 571, 574 (C. C. A. 4th)), it may become a factor of importance. Cf. *Coyle* v. *Commissioner*, 142 F. 2d 580, 582 (C. C. A. 7th): *Rassieur* v. *Commissioner*, 129 F. 2d 820, 827 (C. C. A. 9th). Here there is no going concern involved (R. 20). Moreover, in any event, taxpayer's "appraisal is but one of the factors to be considered", as said by the Circuit Court of Appeals for the Seventh Circuit in *Superior Coal Co.* v. *Commissioner*, 145 F. 2d 597, 598,

certiorari denied April 2, 1945, No. 950, last Term,[10] and (p. 599):

> To hold this basis as controlling when there are other factors relevant to the disputed question of value would amount to the substitution of our judgment for that of the Tax Court.

The "objective test" rather than the "subjective test" has generally been followed by the courts in cases of this character without making use of either phrase, but in the decision of the Fourth Circuit Court of Appeals in *Bartlett* v. *Commissioner,* 114 F. 2d 634, 638, 639 (C. C. A. 4th), where many such cases are collected, it was expressly stated that the time for the deduction of losses is fixed by a standard that is "purely objective." That decision was followed in *First Nat. Bank of Minneapolis* v. *United States,* 58 F. Supp. 425, 427 (D. Minn.).

Both the court below[11] (R. 80) and the Seventh Circuit Court of Appeals in the *Superior Coal Co.* case, 145 F. 2d. 597, 599, certiorari denied April 2, 1945, express disagreement with the holding of the Court of Appeals of the District of Columbia in *Smith* v. *Helvering,* 141 F. 2d 529 (decided by a divided court), relied upon by taxpayer, and

[10] Motion for leave to file petition for rehearing of petition for certiorari denied for want of jurisdiction, June 18, 1945.

[11] In *Beaudry* v. *Commissioner,* 150 F. 2d 20, the court below, citing the instant case, stated again its approval of the objective rather than subjective test as the basis for determining worthlessness of stock.

claimed in her application for certiorari in the instant case to conflict with the decision of the court below. In that case the question was whether shares of stock became worthless, as contended by taxpayer, in the year 1937 when formal dissolution occurred. The company was a closed corporation whose business was suspended in 1929 to the extent that thereafter it had no full time employees. However, after 1929 the corporation disposed of most of its equipment piecemeal and most of its business consisted of casual sales on orders received, and although insolvent it continued a bare existence through small sums paid into it each year by taxpayer. The court said (141 F. 2d at pp. 530, 531):

> The test applied by the Board was stated in the following terms: "The loss must be taken in the year in which it is sustained and at no other time and this means the year in which these shares in every substantial and realistic way become worthless." * * *
>
> * * * * *
>
> The test proposed by the Board in the present case is a highly objective one which disregards what the taxpayer may think of his investment, how much of an optimist he may be, or what he may consider to be the possibilities of future successful operation, or of eventual recoupment. An examination of the cases persuades us that the subjective appraisal of the taxpayer is of much greater importance.

However, the belief of taxpayer as to value is not necessarily the controlling element, and if the *Smith* case holds to the contrary, we submit that it was not correctly decided, both in this respect and also insofar as the Court of Appeals there assumed the function of the Tax Court in weighing the objective and subjective factors involved in the evidence. (See Point II, *infra.*)

The legal standard for which we contend is requisite for fair administration of a tax system based upon annual assessment. Neither the taxpayer nor the Government should be afforded opportunity to select the year in which deductions are taken. The former should not be permitted to save deductions for a year when income is heavy, nor the latter to confine them to a year when it is light. Temptation for evasion must increase if the taxpayer's belief constitutes the controlling factor in determination of year of loss, and difficulty of practical administration be magnified. These considerations of practical administration find added support in the legislative history and the prevailing view of judicial decision. Notwithstanding a taxpayer's honest belief to the contrary, the year for deduction of the loss must be the year in which, all factors being given due weight, events are such as to furnish convincing evidence to the trier of the facts that the stock has actually become worthless in that year.

II

THE FINDING OF THE TAX COURT THAT THE LOSS WAS NOT IN FACT SUSTAINED IN THE TAXABLE YEAR WAS CORRECTLY HELD BY THE COURT BELOW TO BE SUPPORTED BY SUBSTANTIAL EVIDENCE

The question whether particular corporate stock did or did not become worthless in a given taxable year is a pure question of fact. *Morton* v. *Commissioner,* 112 F. 2d 320 (C. C. A. 7th); *Commissioner* v. *Peterman,* 118 F. 2d 973 (C. C. A. 9th); *Coyle* v. *Commissioner,* 142 F. 2d 580 (C. C. A. 7th); *Superior Coal Co.* v. *Commissioner,* 145 F. 2d 597, certiorari denied April 2, 1945. Nor does the circumstance that the Tax Court here based its finding upon stipulated facts make that finding any the less a finding of fact or extend the range of appellate jurisdiction. Since the stipulated facts support the Tax Court's finding that the stock did not become worthless in the year 1937, the process of judicial review is at an end (*San Joaquin Brick Co.* v. *Commissioner,* 130 F. 2d 220, 224–225 (C. C. A. 9th), even though other conflicting inferences fairly may be drawn from the undisputed facts. *Commissioner* v. *Horseshoe Syndicate,* 110 F. 2d 748 (C. C. A. 5th). Contrary inferences and conclusions, even though deemed by the appellate court more reasonable or desirable and also supported by the evidence, are irrelevant so long as there is adequate support in the evidence for

what the Tax Court has inferred. *Commisioner* v. *Scottish American Co.*, 323 U. S. 119, 124, 125; *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231; *Missouri-Kansas Pipe Line Co.* v. *Commissioner*, 148 F. 2d 460, 462 (C. C. A. 3d). The instant case falls precisely within the category recently described by this court in *Commissioner* v. *Scottish American Co.*, *supra* (p. 125) as exemplifying—

> one type of factual dispute where judicial abstinence should be pronounced. The decision as to the facts in this case, like analogous ones that preceded it, is of little value as precedent. The factual pattern is too decisive and too varied from case to case to warrant a great expenditure of appellate court energy on unravelling conflicting factual inferences. The skilled judgment of the Tax Court, which is the basic fact-finding and inference-making body, should thus be given wide range in such proceedings.[12]

Loss, like other deductions, is a matter of legislative grace, of statutory privilege not of right; it does not turn upon general equitable considerations, and only if there is clear provision therefor

[12] Compare the statement in 5 Mertens Law of Federal Income Taxation, Section 28.01, p. 92:

"The loss deduction provision has given rise to a terrific amount of litigation, as is demonstrated by the size of this chapter."

can any particular deduction be allowed. *New Colonial Co.* v. *Helvering,* 292 U. S. 435, 440; *Deputy* v. *duPont,* 308 U. S. 488, 493. Moreover, as this Court said in *Burnet* v. *Houston,* 283 U. S. 223, 227—

> The burden of proof to establish a deductible loss and the amount of it, clearly, was upon the respondent [taxpayer]. *Reinecke* v. *Spalding,* 280 U. S. 227, 233; *United States* v. *Anderson,* 269 U. S. 422, 443.

This includes the burden to establish the loss in the year in which the deduction is claimed. *Lambert* v. *Commissioner,* 108 F. 2d 624, 625 (C. C. A. 10th); *Keeney* v. *Commisioner,* 116 F. 2d 401, 403 (C. C. A. 2d).

Here the Tax Court specifically found the evidence not only (R. 67)—

> insufficient to establish that the stock had any value at the beginning of 1937 and became worthless during that year, it clearly shows that the stock was worthless prior to that year.

The record and the inferences, which the Tax Court was plainly justified in drawing from the record, surely contain ample support for this finding. As early as June 1932, Hartman admitted the allegations of the bill of complaint seeking to place it in receivership (R. 38) and thus conceded that the corporation's business had been and

was then being operated at great financial loss and that it was unable to meet and pay its obligations as they became due (R. 29). The company was forthwith placed in receivership and approximately a year later finally ceased operations (R. 20). As of that day, May 26, 1933, a new company (Hartman's, Inc.) purchased at a bankruptcy sale the assets of Hartman's principal subsidiary, Hartman Furniture & Carpet Company, for $501,000. The stock of the new company was issued to the subsidiary's creditors; stockholders of Hartman were merely given the right to subscribe for stock and debentures of the new company, a right which, however, taxpayer did not exercise.[13] (R. 20–21.)

The receivers' reports, approved by the district court, conclusively establish that Hartman was hopelessly insolvent and that its stock, subject to heavy claims of creditors, was worthless. The first report, approved on August 10, 1934, shows assets of only $39,543 in cash and liabilities consisting of outstanding claims aggregating more than $707,000 of which the receivers recommended that a total of $630,574 be allowed. The second report, filed on July 11, 1935, listed cash assets in the amount of $27,192 and claims of creditors in the same amount as the first report. A divi-

[13] Hartman Furniture & Carpet Company constituted the principal asset of Hartman (R. 26).

dend to creditors of only four percent was at that time recommended and approved and it does not appear that the creditors at any time received anything more out of this insolvent estate. The only other asset listed in these two receivers' reports was the Graham suit (see Statement, *supra*, pp. 4–6) for which apparently no value was stated. (R. 21.) After the Graham suit was settled and subsequently dismissed in May 1937 (R. 66), a final report was filed in September 1937, by the remaining receiver showing only $1,909 in assets and claims totaling $630,574 (R. 21–22). Accordingly, notwithstanding the settlement of the Graham suit, Hartman remained hopelessly insolvent, possessing assets of only nominal value, and the hundreds of thousands of dollars in claims of creditors remained unpaid.

Thus there was here a succession of "identifiable events," occurring many years before the taxable year of 1937, which taken separately or in combination, proved the stock to be completely worthless long before the taxable year and sustained the finding of the Tax Court. These included serious losses over a period of years, the receivership, the receivers' reports, the termination of operations, and the bankruptcy sale of the assets of the principal subsidiary. Similar events have often been held adequate to establish loss of all actual and potential value of stock in the tax-

able year in which they occurred. *DeLoss* v. *Commissioner*, 28 F. 2d 803 (C. C. A. 2d), certiorari denied, 279 U. S. 840; *Jeffery* v. *Commissioner*, 62 F. 2d 661 (C. C. A. 6th); *Industrial Rayon Corp.* v. *Commissioner*, 94 F. 2d 383 (C. C. A. 6th); *Lambert* v. *Commissioner*, 108 F. 2d 624 (C. C. A. 10th); *Bartlett* v. *Commissioner*, 114 F. 2d 634 (C. C. A. 4th); *Keeney* v. *Commissioner*, 116 F. 2d 401 (C. C. A. 2d); see also *Morton* v. *Commissioner*, 38 B. T. A. 1270, 1278–1279, affirmed, 112 F. 2d 320 (C. C. A. 7th) (cf. Br. 17–18, 27).

Despite taxpayer's assertions (see Br. 26, 29, 32), the Tax Court concluded that the evidence failed to establish that the Graham suit was of any substantial value[14] (R. 67). The merits of this suit were not shown, nor probability of recovery nor assurance of collection. The trier of the facts was justified in declining to infer from the stipulated fact—that the defend-

[14] Taxpayer relies (Br. 15–17) on *Louisville Trust Co.* v. *Glenn*, 33 F. Supp. 403 (W. D. Ky.), affirmed, 124 F. 2d 418 (C. C. A. 6th), but there, unlike the instant case, the trier of facts ruled that there was substantial hope of recoupment until the taxable year (in which the taxpayer received through a compromise settlement more than three-fourths what it claimed). The same is true of *Redfield* v. *Commissioner*, 34 B. T. A. 967 (cf. Br. 20–21, 27). *Russel Wheel & Foundry Co.* v. *Commissioner*, 3 B. T. A. 1168 (Br. 26, 28–29) did not involve worthless stock and the debtor was not insolvent.

ants were men of financial responsibility—that they possessed the means to satisfy the creditors' claims of more than $630,000, plus huge damages running into millions, a prerequisite in this derivative suit before any small stockholder [15] might look to substantial compensation for his loss. Certainly the stipulated fact did not compel the inference, and the refusal by the fact finder to make it was neither arbitrary nor unreasonable. On the showing made in this record, the Tax Court reasonably might infer that the value of the suit was not so substantial as to justify the taxpayer in postponing her loss deduction for approximately four years awaiting its outcome. All value had departed from the stock prior to 1937; what was left was at the most contested claims for damages against third parties for destruction of that value. The loss was certain; and a loss must be taken in the year in which it actually is sustained, even though it is "not possible to say beyond imaginable peradventure" (*De Loss* v. *Commissioner*, 28 F. 2d 803, 804 (C. C. A. 2d)) that at some vague future date an indefinite return on the investment is conceivable. *Young* v.

[15] Taxpayer's 1,100 Class A shares (R. 20) constituted less than two percent of the outstanding 60,000 Class A shares and less than one-third of one percent of the total outstanding stock with which she must share on liquidation (R. 25).

Commissioner, 123 F. 2d 597 (C. C. A. 2d);[16] *Clark* v. *Welch*, 140 F. 2d 271, 273 (C. C. A. 1st).

Morton v. *Commissioner*, 104 F. 2d 534 (C. C. A. 4th), cited by the taxpayer (Br. 26, 27–28), is, as the court below held (R. 79), inapplicable to the case at bar. There the court held that the loss of investment in real estate which was foreclosed in 1932 should be recognized as a deduction in 1934 when the litigation in connection with the property was compromised and finally settled. The court pointed out that the litigation subsequent to the foreclosure sale involved the validity of the sale itself and that until it was determined whether the sale was to stand or the property or its equivalent would be recovered by the taxpayer, nothing concerning the transaction had been settled, and therefore final settlement of the litigation was the determinative event which fixed the time of the loss in 1934. There was no question there of total worthlessness of property fixed and definite in a certain year prior to the taxable year, as here. Likewise, *Sabath* v. *Commissioner*, 100 F. 2d 569 (C. C. A. 7th), also relied upon by the taxpayer (Br. 27, 30–

[16] Taxpayer quotes (Br. 22) from the *Young* case and asserts that she complied with that case by claiming a loss for the "earliest year when it may possibly be allowed" and renewing "the claim in subsequent years if there is any reasonable chance of its being applicable to the income for those years." However, taxpayer made no claim of loss in 1932 or 1933, in which her loss appears to have been sustained (see Statement, *supra*, pp. 3–4, 6–7).

31), is, as the court below noted (R. 79), readily distinguishable on its facts. The only loss deduction permitted by the circuit court of appeals concerned the taxpayer's interest in an oil royalty trust; the company had abandoned its runs in the taxable year and had no substantial assets remaining over and above its liabilities.

The statute does not "require the taxpayer to be an incorrigible optimist" (*United States* v. *White Dental Co.*, 274 U. S. 398, 403), nor on the other hand permit him to gamble on the remote hope of such salvage as a claim incapable of rational appraisal may bring. As the Circuit Court of Appeals for the Fourth Circuit said in *Niagara Share Corp.* v. *Commissioner*, 82 F. 2d 208, 211:

> Such a course would result in endless confusion, not only in the accounts of taxpayers, but in the taxing department of the government.

The principle in both instances is the same; to permit the year in which the loss is deductible to rest upon nebulous, uncertain and technical factors is to invite manipulation in the choice of the tax year in which the deduction is taken, in contravention of the expressed Congressional intent. The courts have repeatedly sustained this construction and hold, with the court below, that despite possibility of recoupment, the year of actual loss is the proper year for the deduction, where probability of realization is merely speculative. Nor on the same reasoning, as the cases

also rule, is it material that such a possibility, incapable of rational appraisal at the time of the loss, later results in substantial recovery. *United States* v. *White Dental Co.*, 274 U. S. 398; *Commissioner* v. *Brown*, 54 F. 2d 563 (C. C. A. 1st), certiorari denied, 286 U. S. 556; *Commissioner* v. *Highway Trailer Co.*, 72 F. 2d 913 (C. C. A. 7th), certiorari denied, 293 U. S. 626, rehearing denied, 294 U. S. 731; *Commissioner* v. *John Thatcher & Son*, 76 F. 2d 900, 902 (C. C. A. 2d); *Niagara Share Corp.* v. *Commissioner*, 82 F. 2d 208 (C. C. A. 4th), *Cahn* v. *Commissioner*, 92 F. 2d 674 (C. C. A. 9th); *Hinrichs* v. *Helvering*, 95 F. 2d 117 (App. D. C.). As stated in *Niagara Share Corp.* v. *Commissioner, supra* (p. 211):

> It certainly seems the fairer course to pursue to allow a taxpayer to deduct a loss in the year when suffered and to pay a tax on the amount of the loss recovered, if any, in the year in which the recovery is made.

Moreover, whatever taxpayer recouped here obviously does not represent a recovery in the Graham suit. That action was primarily for the benefit of the corporation (R. 61); however, actually no money was paid to the corporation at all. If this were a settlement of the cause of action stated in the Graham suit (see R. 61), the $50,000 recovered would necessarily have been paid to the corporation's creditors; taxpayer and her co-plaintiffs would have received nothing. Again, under the

complaint of the Graham suit, any recovery by stockholders would be required to be divided among all the stockholders, of whom there were certainly many hundreds, and could not have been limited, as it was, to taxpayer and her eight co-plaintiffs.

Indeed, despite her present claim, taxpayer's own belief in the substantial value of the Graham suit is open to serious question. Her present claim is inconsistent with the loss deduction in the amount of $32,302 (disallowed by the Commissioner) which she asserted in her income tax return for the year 1934 on the basis of total worthlessness of this stock (R. 22). The Graham suit, commenced in 1932, must, at the time the 1934 return was filed, have been pending for at least two years. The Tax Court was entitled to weigh her present claim against her previous contradictory one and draw its own inferences as to the facts. Hence, even on the basis of the subjective appraisal, for which taxpayer urges (see Point I), the evidence is conflicting and the Tax Court surely could reasonably find against taxpayer.

Whether in a given case the likelihood of recoupment is real or, as here found, speculative, is peculiarly a fact question—for the drawing of inferences and the weighing of evidence,—varying with the circumstances of each case. Hence, since the test called for is "practical," not "legal" (*Lucas* v. *American Code Co.*, 280 U. S. at p. 449),

it is for application by the fact finder, and on substantial evidence the finder of facts has here found contrary to taxpayer's contention.[17]

CONCLUSION

The Circuit Court of Appeals correctly decided the issue before this Court on certiorari; its decision in this respect should be affirmed.

Respectfully submitted.

HAROLD JUDSON,
Acting Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
HELEN R. CARLOSS,
I. HENRY KUTZ,
Special Assistants to the Attorney General.
WALTER J. CUMMINGS, JR.,
Attorney.

OCTOBER 1945.

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[17] Cf. *Leiper* v. *Commissioner*, decided April 9, 1942 (1941–42 P-H B. T. A. Memorandum Decisions, par. 42,211), where in the case of another stockholder of Hartman a different member of the Board of Tax Appeals on weighing the evidence likewise found that its Class B stock became worthless prior to 1937 and sustained the Commissioner's denial of a loss deduction for 1937. Taxpayer relies on *Cooley Butler* v. *Commissioner*, 45 B. T. A. 593 (Br. 27, 29–30), but the Board pointed out in the *Leiper* case that the mine in the *Cooley Butler* case had a "demonstrated value" until the taxable year involved.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. * * *

Treasury Regulations 94; promulgated under the Revenue Act of 1936:

ART. 23 (e)–1. *Losses by individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Act: Section 23 (g), relating to wagering losses; section 24 (a) (6), relating to losses from sales or exchanges of property between members of a family or between a corporation and its shareholders;

section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 117, relating to limitation on losses recognized by section 112 upon the sale or exchange of capital assets; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of United States; and section 252, relating to citizens of possessions of United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. * * *

* * * * * *

ART. 23 (e)–4. *Shrinkage in value of stocks.*—A person possessing stock of a corporation can not deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. If stock of a corporation becomes worthless, its cost or other basis as determined and adjusted under section 113 is deductible by the owner for the taxable year in which the stock became worthless, provided a satisfactory showing is made of its worthlessness. * * *

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